

Richard Lambert speech to Jiji Press, 14 February 2007.

I'd like to talk today about two related issues – both of which are controversial, and both of which have been much in the news in the past few days.

The first is the scale and volume of bonus payments in the City of London.

And the second is the growth of private equity.

City bonuses, according to a senior Government minister, are creating a “grotesque” wealth gap in the UK. Peter Hain, the Northern Ireland Secretary and a candidate for the deputy leadership of the Labour Party, claimed over the weekend that 4,000 City workers had received bonuses of more than £1m each. This, he suggested, was a threat to social cohesion - and he called on City institutions to hand over two-thirds of their bonus pool to charity. His message was accompanied by a veiled threat.

“There’s a debate starting,” he said, “and either is it done in a self-policing way...or people will look for other solutions.”

The rapid growth in scale and influence of the private equity sector has also been causing political ripples. A number of trade union leaders both in the UK and across Europe have attacked what they describe as a ruthless form of asset stripping, where immense fortunes have been garnered by the few at the expense of the many.

A recent charitable event in London, aimed at launching a private equity backed foundation for children, was picketed by a trade union, which said that the idea of these people becoming involved in a children’s charity was comparable to King Herod becoming a patron of the National Society for the Prevention of Cruelty to Children.

The news last week that a group of private equity houses were contemplating a takeover bid for J. Sainsbury, the big supermarket group, caused a special outburst of indignation. The well-known economic commentator Will Hutton was especially incensed in his



column in the Observer this Sunday. He concluded the piece, perhaps just a little melodramatically, with the thought that:

“Private equity opens the door to a new Dark Age.”

So what’s going on here, and how should we think about these issues?

City bonuses first.

The first task is to be clear about the role that bonuses play in the economics of City institutions – especially in the investment banks, trading houses, and fund management groups which are where most of the big payments are made.

These are cyclical businesses with volatile earnings, in which the wages and overall compensation bill makes up a very high proportion of running costs. In a good year, the returns on capital are very substantial: in a bad year, these returns disappear.

This is why such firms have always sought flexible ways of paying their people, so that in the good years they get much higher compensation than they do in the bad. So bonuses have the potential to make up a much higher proportion of the pay package than basic pay.

The best way to think of such payments is as a profits share. If profits go up sharply, so does the level of remuneration.

Moreover, this is a winner take all environment, in which it is so important for a deal to get done that the size of the resulting bonus becomes immaterial. And it’s also a world in which star performers can and do move from firm to firm if they think that by doing so they can do bigger deals and earn bigger rewards.

The best analogy is with premiership footballers, although I haven’t yet heard Mr Hain make the comparison.

The stars in premiership football receive enormous payments to keep them loyal to their team, so that the club itself can generate the income that comes from successful performances. And the level of pay drops off dramatically the further down the league tables you go.

The past few years have been extremely profitable for firms in this sector of the City – which is why the profit shares have been so high.

In part, these high profits have been cyclical in nature. Business conditions have been just about ideal, with a strong growth in the global economy – the fastest in a generation or more – and exceptionally favourable financial conditions.

High growth is normally accompanied by tightening credit conditions, as firms borrow more to invest and expand. This time, though, real interest rates have at least until recently remained at very low levels, and the markets have been sloshing around with excess liquidity. That's mainly been the result of the world's central banks running very loose monetary conditions in order to stimulate growth.

But profits growth in the City of London has been driven by secular as well as cyclical trends. The fact is that London has been going from strength to strength, and actually eclipsing New York in some important sectors as the world's premier financial market.

Partly this has been the result of clumsy regulation in the US. But London is also turning out to be the prime beneficiary of a continuing period of consolidation in the global financial markets. More euros are traded in London than in all the member countries of the euro combined, and the City dominates foreign exchange trading internationally.

London is the location for 70 per cent of the global secondary bond market and almost 50 per cent of the derivatives market. Most of Europe's hedge funds are managed here. And last year there were 419 new issues on the London Stock Exchange, including Aim, against 36 on the New York Stock Exchange and 138 on Nasdaq.

This is why all the world's big investment banks have been strengthening their teams in London. Many of the big US firms have been shifting some of their most senior people – with their eye-wateringly large pay packets – to the City.

And the trend has caused real concern in the US. New York's Mayor Bloomberg has commissioned an inquiry into whether and why his City is losing out to London. So has Treasury Secretary Hank Paulson.

Two important points need to be made at this stage.

The first is that – contrary to what you might think from reading some of the commentaries – financial markets are not a zero sum game.

In other words, the fact that someone is making a big profit does not mean that someone else is making a big loss. In a growing economy, it is possible for everyone to benefit.

The second is that London's biggest successes are all in what you might call virtual markets – by which I mean markets that do not depend on a physical trading floor, or on the strength of the domestic economy. Think, for example, of over-the-counter derivatives, foreign exchange trading, or merger and acquisition activity.

Virtual markets don't have to be located in any one place. If local business conditions turn against them, participants can pack their bags and fly off to more favourable locations. In a sense, that's been New York's problem, and London's success.

All these reasons, cyclical as well as secular, help to explain why the profits share being paid out by City firms in the recent past have been so spectacularly high.

And they also demonstrate how easy it would be to kill the goose that is laying the golden egg.

Have there been any beneficiaries, apart from the fortunate few?

The answer, of course, is that there have.

First, the City firms have created very large numbers of jobs. Total employment rose by roughly 10,000 to roughly 330,000 in 2006, and rises of a further tenth have been forecast for the current year. The success of these firms has brought wider benefits to the professional services sector. Three of the world's four largest international law firms are located in London, along with large numbers of high value jobs in the accounting and consultancy sector.

This is why Mayor Bloomberg is so worried. He sees that relative weakness in the financial services sector could drain large amounts of wealth from his City.

The City of London has a broader impact on the national economy.

Financial services share of gross domestic product has risen strongly, reaching 8.5 per cent in 2005 compared with 5.5 per cent in 2001.

The City generates roughly a fifth of all corporate tax revenues in Britain.

The UK trade surplus in financial services is likely to have reached record levels of well over £20 billion last year, and is what's keeping Britain's current account of the balance of payments in reasonable shape.

Twenty years ago, the UK had a small surplus in the exports of manufactured goods, and exported £2 billion of financial services. By 2005, trade in manufactured goods had slumped to a record deficit, but exports of financial services had risen to a record surplus of £19 billion.

So what are the disbenefits of this success?

I think that social cohesion *is* something we should be concerned about. It's true that at a national level only very small numbers of people are benefiting from bumper bonus payments. But at a local level there can be a more noticeable impact – most obviously, in the affordability of housing in the nicer parts of London.

And most of us do feel uncomfortable about a society in which small numbers of people are generating enormous levels of wealth for themselves, while large numbers remain on low incomes.

So what's the way forward?

One answer is straightforward. Let's chop the trees down, and tax those high earners out of existence. At least one person would throw his hat in the air with delight if you did that: New York's Mayor Bloomberg.

The more sensible approach starts with a sense of perspective. Profit shares and bonuses are at cyclically high levels: they won't stay there forever.

But City firms themselves need to get their act together. They should do a much better job of explaining the great value that their success brings to the UK economy as a whole. They should also be more upfront about the positive role that they play in their different communities.

All of them are actively engaged in corporate responsibility programmes – supporting the school system with money and talent, helping the homeless, providing scholarships. Many of the City's individual stars are also substantial donors to charity. No doubt they could and probably should do more.

But at the moment there's an information vacuum. We read about the bonuses, but not about the other side of the story. Those are the circumstances in which the City's critics can make the headlines.

In the end, though, the question is not whether we want to attack City bonuses. It's about whether we want to sustain the success of London as one of the world's great global financial centres.

And I think the answer to that question is clear.

So much for the bonus story.

What about the private equity business?

Does it consist, in the words of one trade union leaders, of "robbers and plunderers" who have "taken over viable businesses and hollowed them out to satisfy their own greed"?

Or does it present, as its participants claim, a dynamic business model that can bring real benefits to the economy as a whole?

There's no doubting its enormous and growing impact on the structure of corporate ownership in the UK. On one estimate, private equity-backed companies account for roughly one in five private sector employees in the UK. And this figure is set to rise further, given the rapidly increasing pools of investment funds being directed into the sector.

My starting point is that private equity offers a compelling economic model, with real potential to raise the efficiency of businesses both in terms of their operations and their financial structure.

It has opened up and expanded a wider source of capital for companies and made possible some really impressive company transformations.

It has helped to address the agency problem inherent in listed companies. Because the managers of businesses backed by private equity usually have a significant equity interest in their success, the interests of managers and owners are very closely aligned.

This means that most of the governance problems in listed companies are automatically resolved. Successful managers in private equity firms are handsomely rewarded. Unsuccessful ones are unceremoniously dumped. You don't need complicated compensation committees: owners of the business can pay the talent what they like. You don't need endless nomination committees either: you just appoint the person you think will do the best job.

There have been very few hostile deals to date, which signifies a willingness of companies to embrace private equity as a rational way forward. Good for the companies they own through a track record of turning companies around, increasing their value and re-floating them, and good for the wider economy.

It is true that time horizons are short – a private equity house typically wants to sell out of an investment within three to five years. But this is actually a lot longer than the holding period of many listed company investors.

And while the business remains in their hands, private equity houses can make big strategic decisions without worrying about the short-term impact on earnings. Managers don't have to spend large chunks of their time talking to investment analysts or journalists. Instead, they can focus entirely on the job in hand.

Since the whole aim of private equity investment is to sell on the asset at a profit after its underlying performance has been improved, managers have a real interest in the long-term health of their business. If they strip out its assets and close down its factories, as the critics claim, they won't have a viable business left to sell at the end of their holding period.

The evidence, at least until recently, has been that companies refloated on the stock market after private ownership have performed better than have other new issues.

And according to data produced by the British Venture Capital Association, private equity-backed companies have created more new jobs in recent years than their publicly listed counterparts.

None of this squares with the allegations of robbery and plunder.

As Permira's Damon Buffini told the Sunday Times the other week,

“In the private equity model, what you have is a real convergence between the owners, the management and the board, and incentives that benefit all three groups. That means communications lines are shortened, we are able to make changes more quickly, and take long-term strategic initiatives. We are not under short-term pressure of public markets, and we do believe that we intimately understand the businesses we acquire.”

It's not all perfect. Business Week magazine has reported a number of cases in the US where disreputable private equity firms have taken large fees out of their investments in

very short periods of time, or even driven firms into bankruptcy in order to seize control of their assets.

But these are exceptions. In most cases, businesses have emerged from private equity ownership a whole lot more healthy than they were when they went in.

Joseph Schumpeter, the renowned Austrian economist, described the way in which capitalism regenerates itself and invents new ways of producing wealth as a process of creative destruction – old ways of doing things are swept away, replaced by modern technologies, financial management and management skills. Staff and capital are re-deployed to more efficient businesses, boosting productivity, wages and living standards.

He could have been talking about private equity.

All the same, it's right that there should be a debate about the growing impact of private equity on corporate ownership in the UK. So far, I've suggested, the results have been almost entirely beneficial.

But the scale of potential deals has increased dramatically over the past year, as the size of investment pools has increased. Last year brought two transactions in the US that were each worth well over \$30 billion, and the Sainsbury takeover, if it were to go ahead, would amount to well over £10 billion.

Private equity houses today have billions of dollars looking for a home. And when you add to this the leverage that comes with bank debt, it's clear that all but a very small handful of UK businesses are now potential targets for private equity houses.

This flood of new money stems in part from the same conditions that have helped to boost profitability in the City more generally – very low interest rates and lots of liquidity. It's also the result of the very high returns that have been made on private equity assets in recent years, in contrast with the sometimes lacklustre performance of the bond and equity markets.

Institutional investors want more of the action.

This raises two broad questions.

One is about risk. The other is about transparency.

It's obvious that an investment pool which has been producing such high returns in recent years must be taking considerable risks. The question is whether these might have broader implications, either for the financial system as a whole or for social and economic policy more generally.

The Financial Services Authority has started a programme to consider the first of these two potential risks.

In its preliminary discussion paper, it showed that in the five largest LBO transactions in the year to last June, the equity component on average was just 21 per cent - although this was cushioned by a layer of subordinated debt, some of which had equity-like characteristics.

However, the intense competition to secure new deals in a sellers' market is having an important impact. In the FSA's words, "The amount of credit that lenders are willing to extend on private transactions has risen substantially. Lending limits are increasing, multiples are rising, transactions structures are being extended and covenants are weakening.

Lending money to support private equity deals is a very attractive business for the banking sector. The FSA study showed that one bank earned almost \$900 million from private equity related activities in the year to last June, while another was shown to generate more than half of its income from this source.

In the FSA's very refined language, "The reliance of banks on this revenue stream may cause them to consider actions that they would normally discount."

You can make of that what you like.

Of course, in today's world of collateralised debt obligations and other forms of repacking and selling risk, it's easy enough for the banks to pass on their private equity exposure. The evidence is that rather than retaining the loans to private equity businesses on their balance sheet over time, most banks are distributing most or all of it on in double quick time to other market participants, such as hedge funds or insurance companies.

But nobody has a good handle on the final destination of all this debt. Who will be left holding the baby if trouble comes?

There seems little doubt that a sudden increase in the cost – or decrease in the availability – of debt capital would cause big problems for investors in some of the private equity owned companies, especially if this coincided with an economic downturn.

But as the Economist suggested this week, the real problems for the industry may actually be those of its success. With so much interest in private equity, more money than ever is chasing deals. To increase the number of deals that are open to them, several of the bigger firms are rumoured to be contemplating hostile takeovers, at least for the funds they are now raising. That would again raise the risks in a transaction.

These are the circumstances in which, as the Economist headlined its commentary, “*Caveat Investor*”.

The second broad question for the private equity industry is about transparency and disclosure.

The pressure on publicly listed companies to disclose more about their affairs grows year by year. The annual report of a big PLC is likely to have doubled in length over the past decade or so, and may well stretch to 200 pages or more.

In contrast, companies more or less disappear out of sight when they pass into private equity ownership. We get few details about their financial performance or business strategies. Just about all we have is a feeling that their managers and investors are making lots of money, one way or another.

Of course this period out of the public gaze is strictly limited in length. Once private equity has done its work, the business will be relaunched in all its glory, with bells and whistles attached. But as larger and larger companies pass into this form of ownership, we risk getting a much less clear picture of the performance of important sectors of our economy.

The main purpose of publishing company accounts is to inform present and future investors about the health of the business. The fact is that private equity investors have a far better view of this than can ever be the case in publicly listed firms, since they are actually sitting at the boardroom table. They don't have to wait for three months after the financial year to be sent a picture of what's going on: they can get the data every day.

But other stakeholders have a legitimate interest in the health of a business, particularly if it operates on a large scale. They include most importantly its customers, suppliers and employees.

A great deal of nonsense has been written about what might happen to customers of Sainsbury's if it were to pass into private equity ownership. If it started to concentrate on financial returns rather than service to customers, no-one would be more delighted than its rivals on the high street. This is a highly competitive industry, and the recent successes of Marks and Spencer and indeed of Sainsbury's itself have demonstrated the way that improved customer service brings financial returns.

As one cheerful blogger responded to Will Hutton's weekend column in the Observer:

"I buy most of my shopping at a medium-sized Sainsbury's. If their service and prices worsen, I shall drive a quarter of a mile further down the road to a giant Tesco's, and sneak into the neighbouring M & S for treats. I couldn't care less how any of them organise their finances."

In less competitive areas of the economy, there are competition authorities and regulators to ensure that customers get a fair deal.

In addition, well run companies – however they are financed – will make sure that their employees and suppliers are fully in the picture about how the business is doing, how its strategy is developing, and how it's performing against plan.

So this issue of transparency and disclosure is more a matter of perception than of reality. By and large, the people who need to know about the performance of the business are likely to be at least as well informed during the period of private equity ownership as are their counterparts in the publicly listed sector.

But perceptions matter.

And this represents a real challenge for all the private equity business houses.

Up until recently, they have operated well below the radar screen of public interest. They have quietly gone about their business and made very few headlines. They have had no interest in public relations, or in communicating with the wider world.

Now they have reached a size where that approach has to change. A first and most welcome sign of this came only yesterday, when Permira's Damon Buffini proposed a discussion with the general secretary of the GMB union, which is one of private equity's fiercest critics.

Whether he gets a constructive hearing is at least an open question, but the fact is that the big firms do need to be taking part in the growing public debate about their role.

They should be leading the discussion about appropriate disclosure structures, and they should be doing more to develop common standards of reporting – for example, about their investment returns.

They shouldn't be leaving it to others to explain their real value to business, and to the economy more generally. They should be playing a more visible and active role in promoting corporate social responsibility.

If they don't start to adapt their approach to match their economic importance, then sooner or later someone is going to do it for them.

And that would be a great pity, both for them and for the well-being of the economy as a whole.